Part III - Administrative, Procedural, and Miscellaneous

Proposed Revenue Ruling Regarding Depreciation of Ethanol Plants

Notice 2009-64

This notice provides a proposed revenue ruling concerning the depreciation of tangible assets that are used in converting corn to fuel grade ethanol.

The proposed revenue ruling concludes that the appropriate depreciation classification for these assets is asset class 49.5, Waste Reduction and Resource Recovery Plants, of Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785, for purposes of determining depreciation under § 168 of the Internal Revenue Code. This conclusion is based on the asset class description, the applicable definition of biomass, and the fact that conversion of biomass into a liquid fuel is the primary business activity and use of the facility. It is expected that this depreciation classification would apply to assets placed in service on or after the publication of a final revenue ruling. Consequently, the Internal Revenue Service will not require taxpayers to adopt this depreciation classification for tangible assets used in converting biomass to a liquid fuel such as fuel grade ethanol that are placed in service prior to the publication of a final revenue ruling.

The Service and Treasury Department request public comments regarding the proposed revenue ruling. A final revenue ruling will not be issued until the comments have been considered. All comments will be available for public inspection and copying.

Comments must be submitted in writing on or before November 23, 2009, and should include a reference to Notice 2009-64. Submissions should be sent to:

Internal Revenue Service

Attn: CC:PA:LPD:PR (Notice 2009-64), Room 5203

P.O. Box 7604

Ben Franklin Station

Washington, DC 20044

Submissions also may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (Notice 2009-64), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Alternatively, comments may be submitted electronically directly to the Service via the following e-mail address: Notice.comments@irscounsel.treas.gov. Please include "Notice 2009-64" in the subject line of any electronic communication.

PROPOSED REVENUE RULING

Rev. Rul. [XXXX-XX]

ISSUE

What is the proper asset class under Rev. Proc. 87-56, 1987-2 C.B. 674, as

clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785, for the depreciation of tangible assets that are used in converting corn to fuel grade ethanol?

FACTS

Taxpayer owns a facility operated primarily to produce fuel grade ethanol. Ethanol is a colorless, flammable liquid that is an organic chemical, and a high octane alternative fuel source. Taxpayer produces ethanol by fermenting starch from corn.

Taxpayer uses a dry milling process to produce fuel grade ethanol. Taxpayer grinds the corn into flour, mixes the resulting corn flour with water, increases the temperature, and adds enzymes to convert the starch in the solution to simple sugars. Taxpayer feeds the resulting mash (water, sugars and non-convertible solids) into fermentation tanks where yeast is added. Over a period of several days the yeast metabolizes the sugars into ethanol and carbon dioxide (CO_2). The CO_2 produced during fermentation may be collected, compressed, and sold as a by-product.

Taxpayer then sends the solution to distillation columns to separate the ethanol from the solids and water. After distillation, part of the output is further processed by dehydration to increase alcohol content by using molecular sieves that separate the remaining water molecules from the ethanol. Once the dehydration is complete, the fuel grade ethanol is blended with 2 to 5 percent denaturant (such as natural gasoline or unleaded gasoline) and sent to storage pending sale.

Taxpayer also processes the solids and other liquids derived from the distillation to produce and sell distillers grains, an animal feed supplement. More than 50 percent of the economic output at Taxpayer's facility is from fuel grade ethanol production.

LAW

Statutory Scheme

Section 167(a) of the Internal Revenue Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business or held for the production of income.

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168, which prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

The applicable recovery period for purposes of either § 168(a) or § 168(g) is determined by reference to class life or by statute. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would apply to any property as of January 1, 1986, under former § 167(m) as if it were in effect and the taxpayer had made an election under that section. Prior to its revocation, § 167(m) provided that if a taxpayer elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary that reasonably reflected the anticipated useful life of that class of property to the industry or other group.

Primary Use Test

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations provides rules for

classifying property under former § 167(m) and, under these rules, property is included in the asset class for the activity for which the property is primarily used (the "primary use" test). Property is classified according to its primary use even though the activity for which the property is primarily used is insubstantial in relation to all the activities of the taxpayer.

Recent appellate decisions discuss the "primary use" standard for asset classification under § 1.167(a)-11(b)(4)(iii)(b). See, e.g., Clajon Gas Co, L.P. v. Commissioner, 354 F.3d 786 (8th Cir. 2004). Courts have concluded that the actual purpose and function of an asset determines its asset class (a use-driven functional standard) rather than the terminology used to describe an asset by its owners or others.

Asset Classes

Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowance under § 168. This revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4, which consist of specific assets used in all business activities (asset categories); and (2) asset classes 01.1 through 80.0, which consist of assets used in specific business activities (activity categories). The same item of depreciable property may be classified in both an asset category and an activity category, in which case the item is generally classified in the asset category. See Norwest Corporation & Subsidiaries v. Commissioner, 111 T.C. 105, 162 (1998).

Asset class 49.5 of Rev. Proc. 87-56, Waste Reduction and Resource Recovery Plants, includes assets used in the conversion of refuse or other solid waste or biomass

to heat or to a solid, liquid, or gaseous fuel. This asset class also includes all process plant equipment and structures at the site used to (1) receive, handle, collect, and process refuse or other solid waste or biomass to a solid, liquid, or gaseous fuel or (2) handle and burn refuse or other solid waste or biomass in a waterwall combustion system, oil or gas pyrolysis system, or refuse derived fuel system to create hot water, gas, steam, or electricity. Asset class 49.5 also includes material recovery and support assets used in refuse or solid refuse or solid waste receiving, collecting, handling, sorting, shredding, classifying, and separation systems. Asset class 49.5 does not include any package boilers, or electric generators and related assets such as electricity, hot water, steam and manufactured gas production plants classified in classes 00.4, 49.13, 49.221 and 49.4 of Rev. Proc. 87-56. Asset class 49.5 includes, however, all other utilities such as water supply and treatment facilities, ash handling and other related land improvements of a waste reduction and resource recovery plant. Assets in class 49.5 have a recovery period of 7 years for purposes of § 168(a) and 10 years for purposes of § 168(g).

Asset class 28.0 of Rev. Proc. 87-56, Manufacture of Chemicals and Allied Products, includes assets used to manufacture basic organic and inorganic chemicals; chemical products to be used in further manufacture, such as synthetic fibers and plastics materials; and finished chemical products. This asset class also includes, among other things, all land improvements associated with plant site or production processes, such as effluent ponds and canals, provided such land improvements are depreciable but does not include buildings and structural components as defined in §

1.48-1(e). Asset class 28.0 does not include assets used in the manufacture of finished rubber and plastic products or in the production of natural gas products, butane, propane, and by-products of natural gas production plants. Assets in class 28.0 have a recovery period of 5 years for purposes of § 168(a) and 9.5 years for purposes of § 168(g).

Rev. Rul. 77-63, 1977-1 C.B. 60, addresses the question of whether assets used to produce alumina are classified in asset class 33.2, Manufacture of Primary Nonferrous Metals, despite the fact that production used chemical processes. The chemical processes were part of the taxpayer's overall process of producing semi-finished and finished aluminum products from bauxite ore that the taxpayer mined. Asset class 33.2 includes assets used in the smelting, refining, and electrolysis of nonferrous metals from ore. Rev. Rul. 77-63 concludes that the chemical processes used to produce the alumina were an integral part of refining of the nonferrous metal and further concludes that all of the assets used in the processing of the bauxite ore into primary aluminum (basic metal), including those used in the chemical processes to produce alumina, are classified in asset class 33.2. However, the revenue ruling provides that assets used to process the alumina for use in activities other than those required to produce the basic metal should be classified in other asset classes.

ANALYSIS

Asset class 49.5 specifically applies to assets used in the conversion of biomass to a liquid fuel. For purposes of asset class 49.5, the term "biomass" means any organic substance other than oil, natural gas, or coal, or product of oil or natural gas or

coal. This definition of biomass is consistent with the definition in the energy credit provisions that were enacted near the time asset class 49.5 was first established in 1979 by Rev. Proc. 79-26, 1979-1 C.B. 566. See § 48(l)(15)(B)(i), (l)(3)(B) as in effect on the day before the date of enactment [11/5/90] of the Revenue Reconciliation Act of 1990, Pub. L. 101-508. The depreciation and the energy credit provisions are both based on cost recovery concepts.

The corn used in Taxpayer's facility is biomass, that is, an organic substance other than oil, natural gas, coal, or a product thereof. Likewise, the fuel grade ethanol produced from corn (biomass) at Taxpayer's facility is liquid fuel for purposes of asset class 49.5.

Asset class 28.0 of Rev. Proc. 87-56, which includes assets used to manufacture basic chemicals, is not the appropriate asset class for Taxpayer's depreciable tangible assets that are used in converting corn to fuel grade ethanol, even though ethanol is an organic chemical. The individual, intermediate processes within Taxpayer's facility, particularly distillation and dehydration, may be similar or identical to the processing steps that take place in the manufacture of chemicals. However, the mere use of a chemical process in the production of a product does not require an activity to be classified as chemical manufacturing. In Rev. Rul. 77-63, producing alumina by a chemical reaction as a step in the nonferrous metal refining process did not preclude classification in the asset class that specifically applies to manufacturing primary nonferrous metals. Similarly, converting corn, a biomass, to fuel grade ethanol, a liquid fuel, by chemical processes does not preclude classification in the asset class

that specifically applies to the conversion of biomass to fuel.

Further, Taxpayer is primarily engaged in producing fuel grade ethanol (liquid fuel) from corn (biomass) at this facility. Under the “primary use” test of § 1.167(a)-11(b)(4)(iii)(b), Taxpayer's activity is described in asset class 49.5.

HOLDING

The proper asset class under Rev. Proc. 87-56 for depreciation of tangible assets used in converting corn to fuel grade ethanol is asset class 49.5 (other than § 1250 property not described in asset class 49.5 and assets classified in asset classes 00.11 through 00.4 of Rev. Proc. 87-56).

PROSPECTIVE APPLICATION

Pursuant to § 7805(b)(8), the Internal Revenue Service will not apply the holding in this revenue ruling to tangible assets that are used in converting biomass to a liquid fuel such as fuel grade ethanol that a taxpayer places in service before [INSERT PUBLICATION DATE OF FINAL REVENUE RULING].

DRAFTING INFORMATION

The principal author of this notice is Ruba Nasrallah of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Nasrallah on (202) 622-4930 (not a toll-free call).